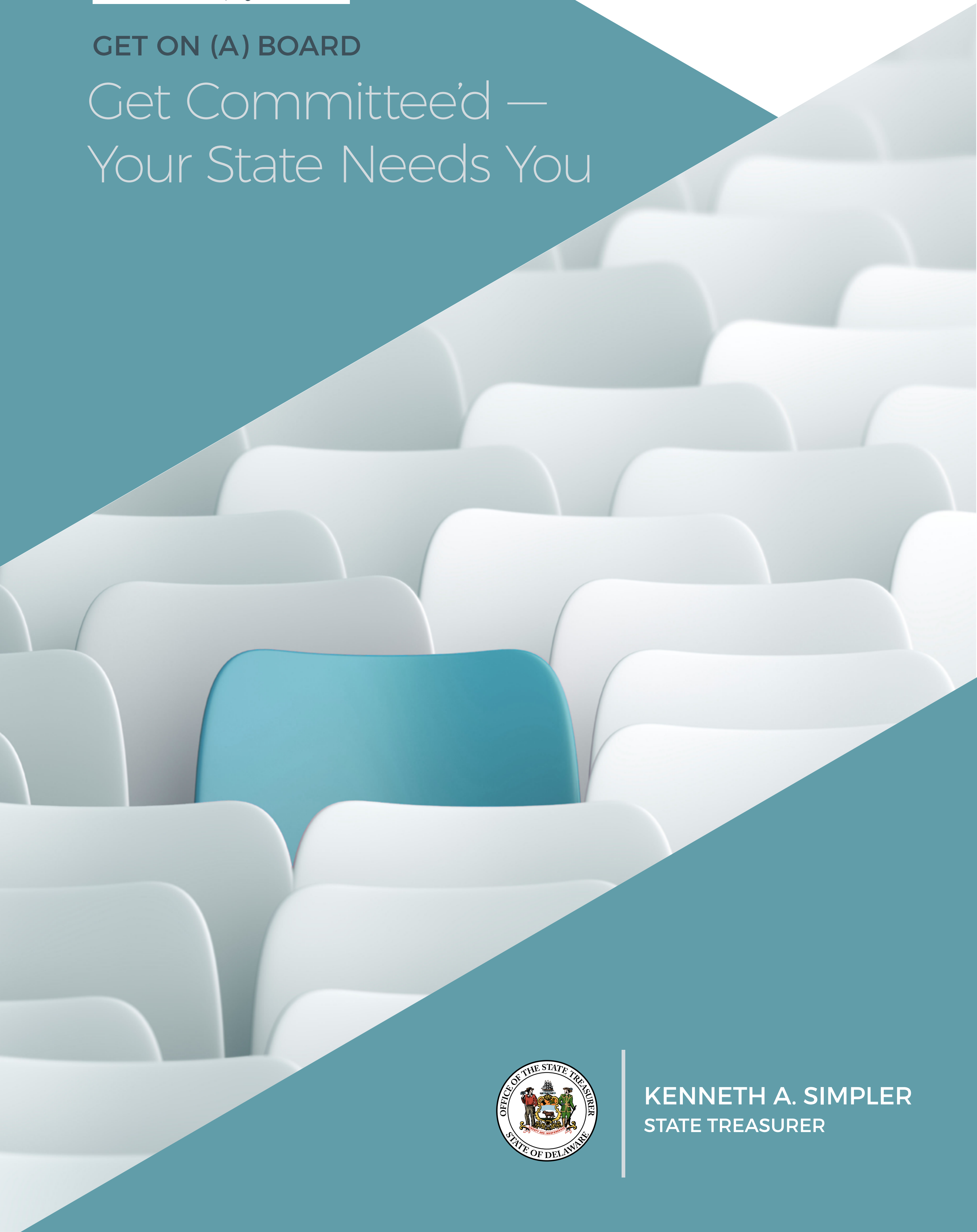
NEWSLETTER | Q4 2018

GET ON (A) BOARD

Get Committee'd — Your State Needs You



KENNETH A. SIMPLER
STATE TREASURER

INTRODUCTION

A lot can happen in four years.

On November 28, 2018, I attended my last meeting of the Cash Management Policy Board as State Treasurer. By no coincidence, but rather through careful planning and deliberate execution, the meeting brought to different stages of completion three distinct strategic initiatives on which my Office and the Board have collaborated.

At the top of the order was the first quarterly performance report on a new platform for the State's investment portfolio that was put in place as of the beginning of the current fiscal year.

That framework was nearly three and one-half years in planning, design, contracting and implementation, and marks a departure from a scheme in place for nearly four decades.

Second was a vote to award contracts to a consolidated set of financial service companies to take on the totality of banking business for the State of Delaware — a holistic approach without precedent.

The hard work of implementing this vision across all state agencies will take at least as much time as the two and one half years spent on the due diligence and deliberation of the revised banking platform.

Finally, a memorandum representing the better part of a year's worth of research was delivered to the Chairman and certain members of the Board who participate as officers in the State's debt issuance process.

The memo invites consideration of an expansion of the Board's mandate to provide for the oversight and review of Delaware's debt policies and practices. That process is projected to require another 18-24 months to study, legislate and implement.

At the end of the two-hour meeting, John Flynn reflected on his 38 years of serving as Chair of the Board: "[C] ompared to the previous 34...we have done more to help the State in the last four years than I can remember."

A lot can happen in four years when the leadership and staff of a state agency and the members of the oversight board they administer are pulling together and engrossed in the good work of simply making our government's operations run more smoothly, securely and efficiently.

Four years can also be a slog when the opposite is true.

A BRIEF LOOK BACK

Those who have no inkling of what the Cash Management Policy Board does might still have had their memories jogged by the dry and obscure sounding committee's name.

The Board featured prominently in news headlines for a good portion of my predecessor's term in office. That notoriety stands in stark contrast to its unheralded role for much of its 40-year history.

The Board was put in place in 1981 as part of a series of reforms aimed at improving Delaware's financial condition and fiscal practices.

Specifically, the Board was chartered to set policy for the investment of state monies by third party managers. This was deemed prudent in so far as all of the State's funds had previously been deposited with Farmers Bank, an entity that while effectively controlled by the State had nonetheless mismanaged its way into insolvency and receivership.

Under the new advisory arrangement, the State Treasurer was appointed to serve as one member of a nine-person policy-making group that was otherwise split between those serving in ex officio capacities — the Secretary of Finance, the Controller General and the Secretary of State — and those public members appointed by the Governor and confirmed by the Legislature.

The State Treasurer remained the day-to-day administrator of state funds, and retained authority for managing collections and payments, movements of funds across state government and the engagement of banks and investment managers to facilitate those activities. In all cases, however, those actions were to be effected within the policy guidelines determined by the Board.

This division of authority between the State Treasurer and the Board is not clear-cut, but requires some give and take. That process broke down during my predecessor's term in office, leading him to contest what he perceived to be the infringement on his constitutional authority as an elected official by the determinations of the unelected members of the Cash Management Policy Board.

Midway through his term in office, those differences had gone well beyond the boardroom, bubbling over into disagreements with other key branches of state government, most notably the Governor's Office.[1]

Ultimately, their resolution required both a legal determination by the Attorney General as well as legislation passed by the General Assembly.

The Delaware Code was amended in 2013 to clarify some ambiguities over the specific matters that had been focal points of the clash between the Treasurer and the Board.

In general, however, the new provisions simply restated what had always been the intent of the original legislation: the Board sets policy; the Treasurer administers pursuant to such policy.

There was much ado made of this legislation and a significant amount of press was spent debating if and how the Treasurer's authority had been reduced relative to the Board.

Lots of ink was also spilled on stories of personal animosity between the Treasurer and members of the Board, as well as speculation on what influence the Governor's appointed Board members had over his administration's determination to "punish" the State Treasurer.

Obscured in all this was the fundamental observation that the Board is a creation of the Legislature, and represents a means for the 62 members of the General Assembly to exercise their critical role in overseeing the executive branch of government.

Conflict between these branches is not only unsurprising, it is by design.

1 As a minor historical footnote, this drama finally ran its course some four years after the events that precipitated it, when the former treasurer and the new governor reached a settlement involving the payment by the State of $22,500 to dismiss all Freedom of Information (FOIA) requests related to this matter.

THE ROLE OF BOARDS IN STATE GOVERNMENT

The basic constitutional framework of our federal and state governments involves a separation of powers among the executive, legislative and judicial branches.

As between the legislative and executive branches there is a shared power over the purse: "the executive proposes, and the legislature disposes" (as the saying goes). Likewise, in the operation of governance, there is given to the executive branch the power to effect, and to the legislature the power to oversee.

In Delaware, that relationship may not be as clear when applied to independently elected offices such as the Treasurer, the Auditor of Accounts and the Insurance Commissioner.

But, in the scheme of checks and balances, these are simply other executive branches akin to the Governor's Office that share authority for governing with the Legislature.

The fact that the General Assembly frequently delegates to the Governor the obligation to appoint members to the boards, committees and councils it creates across state government may also sow confusion as to "who" is exerting authority.

This appointment power, however, is a matter of administrative convenience, as the Governor maintains a staff whose full time role is to accept, vet and approve applications for appointments to the roughly 400 state boards and committees currently in existence (or at least listed as extant on the Governor's website).

In some instances, as is the case with the Cash Management Policy Board, the Governor's appointees must be submitted to the General Assembly for approval. However, even where the legislative branch does not put the individual composition of a board under its ultimate discretion, it retains a power over the whole.

Boards and committees created by the General Assembly receive periodic (e.g., every 5-7 years) "sunset reviews," where their conduct is examined and purpose reassessed, not infrequently resulting in some legislative action or mandated follow-up.

Moreover, the Legislature need not wait on any periodic review to alter, amend or eliminate boards and committees; such legislation can be taken up by policymakers at any time. [2]

The General Assembly relies on the boards, committees and councils that it creates to extend its oversight capacity. With some 17,500 employees (which does not count local educators) and operations that extend into almost every field of industry, the scope of government is simply too vast for a part-time legislature with minimal staffing to monitor on an ongoing basis.

As I have seen first-hand in my service on more than a dozen committees, councils and task forces across state government, the efficacy of this model varies from board to board.

Effectiveness can even fluctuate on the same board over time given the composition of its members and the context of its challenges.

For instance, my predecessor and I both administered a Cash Management Policy Board comprised of a majority of the same individuals.

The background dynamic of legislative and executive tension were present in both cases. Operational demands were also comparable, and the financial environment was similar for a good amount of our respective tenures.

What therefore is to explain periods of decidedly different progress on the Board? The four years preceding my term — even as witnessed in the minutes under the drafting of my predecessor's administration — were fraught with what appear to be turf battles and a high level of unproductive confrontation.

Conversely, differing views during my term were channeled constructively, allowing for what the Board's Chairman deemed an unprecedented level of productivity.

As our State relies on boards, committees and councils to do yeoman's labor, it is worth examining what worked in my experience and how a balance was struck between the executive's operating autonomy and the Board's oversight responsibility. There is much to be gained in fostering such successful collaborations.

2 In fact, there were amendments to the Delaware Code affecting both the Board and the State Treasurer enacted through both processes during my predecessor's term in office. In both 2012 and 2014, modifications were made extemporaneously to address the ongoing dispute described above. In 2014, additional amendments were passed as a consequence of a scheduled sunset review.

THE WORKINGS OF THE CASH MANAGEMENT POLICY BOARD

The Cash Management Policy Board is comprised of two subcommittees, banking and investments, each of which is made up of five members of the full board.

The Board Chairman serves on both subcommittees, as do the State Treasurer and the Secretary of Finance. Two pairs of the four other public members are assigned to each of the Banking Subcommittee and the Investment Subcommittee based on their respective backgrounds in financial services and asset management.

The Board and each subcommittee meet at least once per calendar quarter. Issues of complexity relevant to the subject matter of each subcommittee are first wrestled with at that level and then recommended for action to the full board.

The Office of the State Treasurer supplies the administrative support for all three panels, including staffing meetings, taking minutes, preparing materials and responding to follow up.

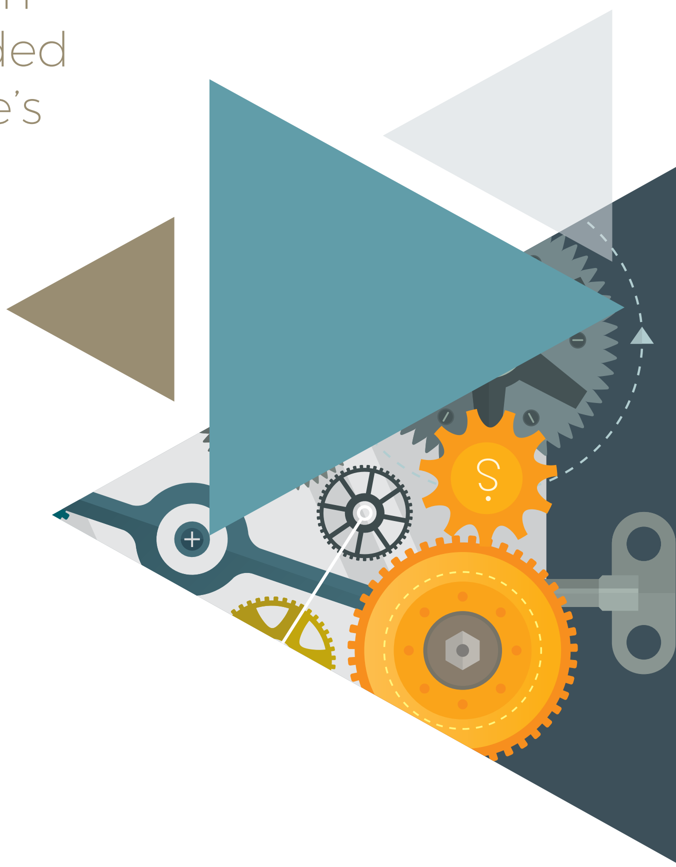
From the perspective of the office staff, the public meetings serve as milestones and inflection points for the completion of work that requires Board approval.

Policy shifts that would impact existing guidelines, final contracts for third-party banking and investment services, and review of portfolio performance are all routinely brought to the Board and its subcommittees for discussion and approval.

Over the past four years, my office has undertaken significant reforms in three areas where the Board has historically exercised varying degrees of engagement:

- in the case of the redesign of the investment portfolio, this was an area where the Board had always maintained a high level of policy-making discretion and active review;
- in our project to restructure the banking architecture, we were dealing with operational issues over which the Board had maintained significantly less oversight and done little policy-making; and
- our proposal to have the Board's responsibilities expanded to include the review of the State's debt policy and practice represented an altogether new mandate, completely outside the Board's existing purview.

Notwithstanding these very different contexts, the Board served as both ultimate arbiter of, and value-added partner with respect to, our Office's initiatives.



REDESIGNING THE INVESTMENT PORTFOLIO

The Board's focus over time has been on monitoring the performance of, and overseeing application of its investment guidelines to, Delaware's cash portfolio.

Since the Board was put in place, state funds have been apportioned between 6-12 outside managers who are contracted by the Treasurer's Office every 3-5 years pursuant to a competitive bidding process with final approval by the Board.

Funds under management vary over the fiscal year, averaging between $1.6 - $2 billion.

The members of the Board are highly familiar with the State's investment portfolio and well acquainted with the related operations of the State Treasurer's Office.

The longest serving public appointees to the Board have worked with six different State Treasurers and experienced several market cycles during their tenure. They have intervened directly in the management of the portfolio on an emergency basis in times of crises, but in general, their focus has been on setting policy.

As a new Treasurer, I immediately became both a member of the Board and the head of the agency responsible for its administration.

My background as an asset manager provided me with a level of credibility with the Board, but also aroused suspicion that I might interpret my role as one of active management (as opposed to investment policy development and oversight).

From my perspective, I was wary as to the Board's tempestuous relationship with my predecessor and concerned that their experience might lead to a territorial defense of the status quo.

We were able to overcome the initial reservations on both sides by working together in two capacities. On the one hand, we were fortunate to have an immediate project to retain managers for the State's endowment accounts, a hands-on process with a clear deliverable under a short time frame.

On the other hand, we committed material time in our first several meetings to the development of a long-range plan to examine each component of the State's cash management operations, an open-ended inquiry of broad scope with no preconceived set of outcomes.

In the first year, we collaborated not only on the engagement of the endowment managers through the request for proposal (RFP) process, but followed that with the same team of Board members and OST staff to hire a new consultant for the Board. (Notably, the outgoing advisor had been engaged by my predecessor without the Board's involvement and answered directly to the State Treasurer.)

These working experiences allowed us to streamline the RFP processes that were subsequently employed to replace the custodian for the portfolio as well as the nine cash managers.

By the end of four years, we had systematically rebid all outside vendors attendant to the investment portfolio. These joint exercises built respect for one another's work ethic, management style and organizational skills.

A parallel process led to even more momentous change: the first overhaul of the cash management guidelines since their implementation in 1982.

That process began with a series of modest amendments to specific provisions of the guidelines to better enable investment managers to deal with the Federal Reserve's decision to begin raising interest rates (after several years where the Fed's main policy rate had been held flat and near zero).

While there was disagreement as to the scope of these changes, the discussion of their need constituted the first steps towards the development of an intellectual framework for revisiting the guidelines in their totality.

Since inception, the Board has operated under a three-part mandate to ensure that state funds are safe, liquid and earn an acceptable rate of return.

While safety of funds always has been paramount, the means for determining the State's operational cash requirements never has been clear.

Over time, this has resulted in an uncertain balancing of the need to keep investments in short-dated notes that earn very little yield but suffer no loss of principal when sold, versus longer-dated bonds that earn greater returns but carry a risk of loss if they are sold prior to maturity. [3]

In order to resolve the question of cash needs, we undertook an extensive examination of the State's receipts and disbursements from periods of budget surplus and deficit.

By examining daily cash flows over a decade (including the period of the Great Recession) we were able to establish an estimate of the State's maximum cash requirements and commit funds in excess of that base to a tiered reserve structure of increasingly longer maturities.

The redesigned investment portfolio meets the liquidity needs of the State while earning a yield that nearly would have doubled returns in the past 10 years and is projected to be 20-25% higher over periods of more normalized interest rates. [4]

No changes were made that lower the quality of assets or security of the funds; in fact, the State's "Rainy Day" monies, or emergency funds, now are held in more liquid accounts.

Overall costs of managing the new portfolio, as measured by custodial, consultant and managements fees, are slightly lower with higher service levels embedded in the new contracts.

Operationally, we also improved on the transparency and equity of returns paid on school district and special agency funds, and our overall forecasting of earnings reportable to the General Fund is significantly more sophisticated.

The extent to which we redeveloped investment policies and procedures related to the State's cash management functions demonstrates that material improvement is possible even where a board has been actively involved and has extensive experience.

The keys to our success in this context were the engagement in collaborative exercises that leveraged that existing experience and learning and an open-ended and open-minded commitment to examining all facets of our operations.

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higher over periods of more normalized interest rates.[4]

3 The lack of a clear understanding and agreement between the Board and the former Treasurer as to the balance between liquidity and yield were partially to blame for material losses suffered by the portfolio in 2013 (the only year of which I am aware when the total portfolio return was negative).

4 NEPC, the consultant to the Board, modeled both the new and current portfolio designs over a range of varying market conditions and historical periods. On average, the new design produced returns that were 100 basis points, or 1%, higher than the current portfolio. In the past 10 years, a period of ultra-low interest rates, the portfolio has returned less than 1.25% on average per annum. The additional 1% in this period represents an increase of more than 80%. In an environment where the portfolio earns as much as 4-5% per year (which it did in the higher interest rate market of the early part of this century), the additional 1% would represent a 20-25% improvement.

RESTRUCTURING THE BANKING ARCHITECTURE

In seeking the Board's assistance in rebuilding the State's banking architecture, we did not start with a comparable level of engagement in setting guidelines or familiarity with state operations.

Banking activities are less subject to policy prescription and performance review than the investment portfolio, and therefore had not historically figured as prominently in the Board's oversight.

One advantage we did have was the professional experience of the two public appointees who serve on the Banking Subcommittee.

A second advantage was that our banking review did not proceed in tandem with the investment portfolio redesign, but followed some 18 months in arrears, allowing us to leverage key insights from that process.

During our extensive review of the investment guidelines, we discovered significant shortcomings in our banking operations.

While the Board's guidelines required the collateralization of all cash on hand, actual practice deviated substantially from that mandate, insuring as little as 5% of intra-day balances.

Similarly, though the Delaware Code provided for the Board's oversight over all state monies (with the exception of pension and retirement funds), a trove of school district and agency banking accounts totaling close to $60 million were found to be outside the accountability of the State's systems.

Rather than attempt to manage these problems without input from the Board, we presented them to the Banking Subcommittee for discussion, examination and feedback. We also brought to the Board's attention material problems we had with outside banking partners.

The bankruptcy and acquisition of the key vendor for the State's system for accepting credit card payments became an immediate instance for working together to understand the severity of the situation and design an RFP to replace that organization.

Likewise, we collaborated on the investigation into the State's provider for the direct deposit of pension and payroll payments when that national bank was found to have defrauded Delaware accountholders.

In that instance, we abandoned a planned RFP for such services and instead replaced the vendor on an emergency, expedited basis approved by the Board.

Far from undermining our Office's credibility, these experiences bolstered support for our efforts to modernize and improve on banking operations.

Bringing Board members in to help solve the key details of our banking challenges rapidly accelerated their learning curve.

These exercises also made clear to all of us that the network of our banking vendors and related practices had been put into place thoughtfully, but serially over time.

Never had there been a comprehensive examination of how they all fit together or a holistic inquiry into their overall efficiency and effectiveness.

One reason that such a process had never occurred was simple lack of human resources. The Office of the State Treasurer was neither organized nor staffed to enable an in-depth review, much less participate in the day-to-day servicing, of the banking operations of all state departments and divisions.

Rather, the Office had historically engaged vendors on behalf of the State at the enterprise level and allowed each agency to individually implement and manage its own application of the contracted services.

To undertake a proper review of our current network required us to form an inter-agency banking task force and engage an experienced outside consultant.

The findings from that exercise proved up what we had come to anticipate: the whole was less than the sum of its parts.

A new structure, if implemented globally, could lower overall out-of-pocket expenses, enhance cyber-security protections and increase the productivity of scores of financial personnel across state government.

To make that vision a reality would necessitate the collaboration between not just our Office and the Board, but also the backing of the State's Government Efficiency and Accountability Review Board (GEAR), and in particular its Financial Services Delivery Committee.

With the support of both groups, our banking architecture review became one of the Governor's signature accountability undertakings.

The work that has ensued culminated most recently with the conclusion of the RFP process and the vote of the Board described in the introduction above. The project to restructure the State's banking architecture now moves from concept and contracting to implementation.

This stage will involve increased reliance on both the Board and GEAR to help shepherd a process that will take several years to complete and will outlive my administration and perhaps even that of the current Governor.

The time invested in making both the Board and GEAR fully cognizant of this undertaking and active partners in its fulfillment may prove to be the institutional glue that holds this project together over the long term.

A process that we began with a rapid education of Board members and some trial by fire, infused with transparency and humility through our disclosure of operating challenges, and ultimately resourced with support beyond our own office, likely will prove our single greatest accomplishment for the State when completed.

REVIEWING DEBT POLICY AND PRACTICE

In a final testament to the usefulness and import of boards in state government, our Office has proposed an expansion of the powers of the Cash Management Policy Board to include the review and oversight of the State's debt policies and practices.

While this mandate is outside the current scope of the Board's authority — and would require both gubernatorial and legislative action to implement — our experience in redesigning the investment portfolio and restructuring the banking architecture suggests that there is an opportunity to build on and emulate that success in the area of debt issuance and management.

Currently, there is no formal public body that oversees Delaware's debt practices and policies; nor does the State conduct regular assessments of its debt affordability or monitor metrics that other states use to measure debt feasibility.

Instead, the State relies on its four bond issuing officers — the Governor, Secretary of State, Secretary of Finance and State Treasurer — to approve each issuance of general obligation debt with the assistance of outside bond counsel and advisors. This process falls well short of an ongoing and comprehensive examination of policies and practices.

The Board, on the other hand, is ideally positioned to take on this role owing to its composition and current mandate. Three of the State's four bond officers serve on the Board, and the administration of the debt issuance and management processes is shared among the agencies administered by two of them.

The Board therefore provides a ready forum for a more regular review of these officers' debt issuing roles and responsibilities.

Strategically, the Board is engaged on the "buy side" of fixed income markets, overseeing the State's cash portfolio of debt securities and monitoring the performance of bond markets.

The State's issuance of municipal bonds takes place on the reciprocal "sell side" of this marketplace, presenting an opportunity for the State to leverage synergies from the Board's policy-setting and advisory roles.

The precise scope of the Board's work should be the subject of extensive discussion but could include responsibility for conducting or commissioning periodic debt affordability studies, recommending changes to the State's debt limit statutes, assessing and proposing alternative means of financing capital projects, approving the engagement of the State's bond issuing consultant and outside legal counsel, reviewing and advising on the State's debt-related practices, and otherwise serving as an independent resource to the bond issuing officers.

Overall, an expanded Cash and Debt Management Policy Board could take on proactively the challenges that foreseeably will receive the attention of the agencies that bestow ratings on state debt issues.

Using the Board, Delaware has both the opportunity and means to build on its fundamentally sound approach to the management of its debt portfolio, further bolstering the case for its AAA bond rating and insuring the State of low borrowing costs well into the future.

CONCLUSION

As I contemplate my imminent departure from public office, the work that has gone on between my administration and the Cash Management Policy Board is a source of both pride and hope.

For those members of the Board who will continue on, particularly those members of the public who serve without remuneration and with little recognition, I want to say "thank you."

John Flynn, Dave Marvin, Mike Karia, Warren Engle and Lynda Messick, your contributions to our State have been both significant in quantity and substantial in quality.

Knowing that Lynda is taking her "retirement" contemporaneously with my own, the task falls to the Governor to appoint someone who will continue to imbue this Board with the professionalism and integrity that have come to characterize its comportment and character for almost four decades, an obligation that I have little doubt he will fulfill.

From the perspective of the staff with whom I have worked these past four years, the carriage of the Office of the State Treasurer now falls to you and my successor.

Together, you will have the opportunity to bring new ideas to the table and advance initiatives that were not part of the strategic plans of my administration.

I wish you great success in these endeavors while encouraging you to continue to share your vision with the Cash Management Policy Board and the other boards that the office administers.

The members of these boards have invested greatly in building the intellectual frameworks that define their missions, even as they have labored to assist with the operational challenges that face our Office. Continue to take advantage of their wisdom.

To my successor, Treasurer-Elect Davis, I hope that when the time comes to attend your last meeting of the Board — in whatever incarnation it may then have taken on — that your experience, like mine, is one that conjures feelings of amicability with your fellow members as well as a shared sense of accomplishment. Truly, these collaborations are the essence of good government.

Finally, for the members of the public to whom I have addressed these missives over time, and who have endured their ever-growing length and adventure into more obscure but erstwhile topics, I say "Get on [a] Board; Get Committee'd."

The State's website lists hundreds of boards, committees, councils and task forces, the application form to apply to any of which is only a few pages long. For convenience, I include the link here: https://governor.delaware.gov/boards-commissions/.

If you take nothing else from this piece, take this: ordinary citizens serving on boards can have an incredible and outsized impact on the success of our state government. If you are not a financial professional, you do not have to serve on the Cash Management Policy Board.

Wherever your interests lie and whatever your experience may be, chances are that there is a board somewhere in state government that has an appropriate opening. Find it and fill it.

Your State Needs You.

Ken

Ken Simpler, Delaware State Treasurer

Read Ken's newsletters online or sign up to receive them via email at treasurer.delaware.gov.

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Bipartisan Budget Accord: Framing a Grand Bargain

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Caring About the State's Healthcare Plan

A Whole Lot of Alliteration: Spending Sustainability, Sufficiency and Soundness

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First (and Lasting) Impressions: My First 100 Days

Consider inviting Ken to address these topics at your organization's next meeting or event.

Please contact us to schedule:

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